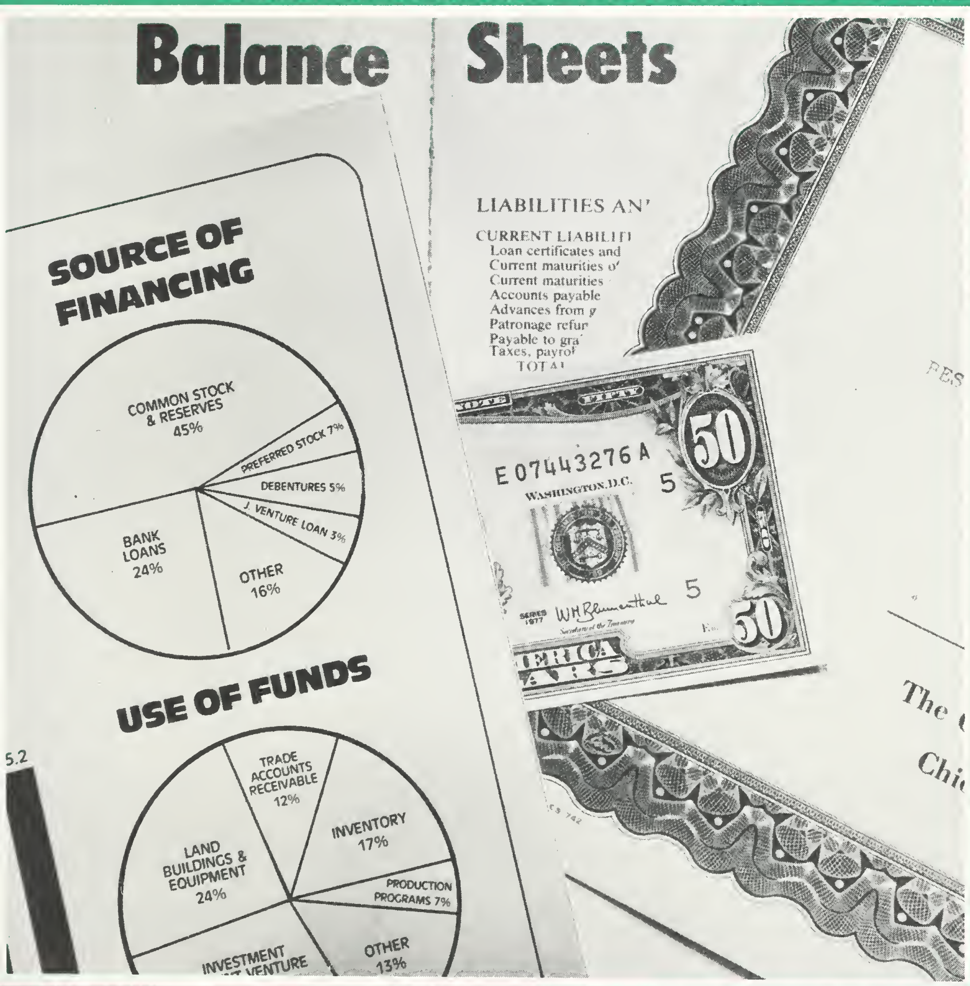
Cooperative Financing And Taxation

FARMER COOPERATIVES IN THE UNITED STATES
COOPERATIVE INFORMATION REPORT 1
SECTION 9

UNITED STATES DEPARTMENT OF AGRICULTURE
AGRICULTURAL COOPERATIVE SERVICE



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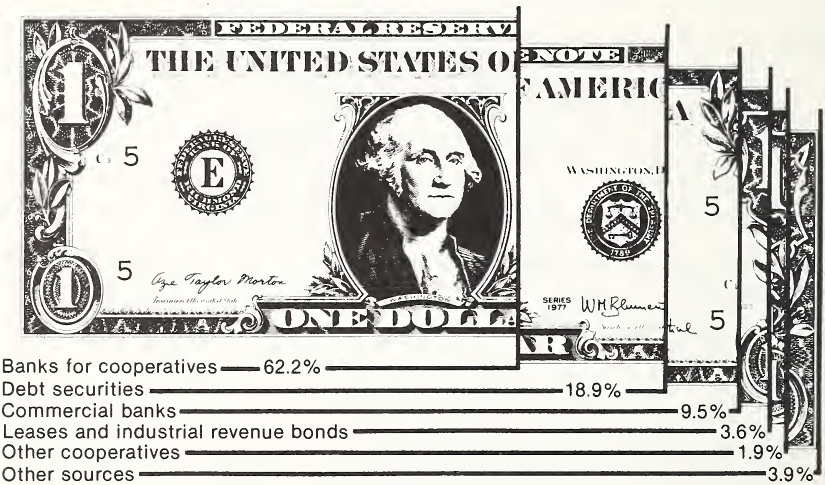


Cooperative Financing And Taxation

As farmer cooperatives have grown and expanded their marketing, farm supply, and other business services, their financial needs have increased dramatically.

Because a cooperative is organized by and for its members, it follows that the members who receive the benefits should provide the risk capital to operate their business. It also follows that the risk or equity capital should be furnished by the members in direct proportion to their use of the services and jointly-owned facilities. Members receiving the greatest benefits—those using the cooperative to the greatest extent—should supply a proportionally greater share of the risk capital.

Most farmer cooperatives began business as small informal groups of farmers trying to increase their income through joint action. In the early years of many of these new cooperative ventures, local investors and general farm organizations played an important role in providing advisory and technical assistance and furnishing some "seed money." In general, however, producers themselves furnished most of the capital to operate their cooperatives. Many considered the use of nonmember capital a threat to their cooperative character, and this psychology definitely influenced their financing decisions.

As cooperatives grew, however, and their marketing, farm supply, and other business services expanded, they found it neither wise nor necessary to rely entirely on internal or equity financing to meet all their financial needs. As a result, in recent years their borrowed capital has increased at a much faster rate than their member capital. Factors bearing on this situation are: (1) the amount of net savings cooperatives generate; (2) the amount of such savings retained for capital purposes and the amount subject to income taxes; and (3) the extent to which per-unit capital retains are used.

Financing With Equity Capital

Farmers finance their cooperatives by using most of the standard methods of other business corporations plus some that are unique to cooperatives, such as per-unit capital retains and allocated revolving capital funds. A little more than two-fifths of total capital requirements of cooperatives comes from member-patrons who use their cooperatives to market their products, obtain their farm supplies, or furnish various farm services.

In addition to the capital derived from member patronage, small amounts of equity capital may be obtained from non-member patrons, other cooperatives, individuals, and firms and organizations interested in the welfare and success of cooperatives in their communities.

Sometimes the growth of a cooperative, including the range and quality of its services, may be seriously hindered by lack of capital or credit. A serious shortage of capital usually reflects inadequate capital contributions from member-patrons. Yet a sufficient base of equity capital is essential if cooperatives are to obtain loans at reasonable rates. Some cooperatives have difficulty borrowing because lenders consider the financial participation by their membership inadequate. Cooperatives must maintain a balanced capital structure. That is, producer-members who own and control cooperatives must be willing to provide, on a continuing basis, a substantial portion of the capital needed.

Equity capital may be defined as that which a cooperative obtains for capital purposes without assuming a legal obligation to redeem it at a stated time under stated conditions. It provides the necessary element of ownership and control any business must have. It is the risk capital. It serves as a buffer to absorb operating losses and any shrinkage in assets that may occur.

The most common methods that members use to provide equity capital to their cooperatives are: (1) Purchasing capital stock or other types of equities; (2) leaving a portion of the net savings of the cooperative in it; and (3) authorizing the cooperative to make deductions from sales proceeds of their farm products—usually called per-unit capital retains.

Farmer cooperatives had an estimated $7.7 billion of equity capital or net worth outstanding at the close of fiscal year 1976. This constituted 42 percent of total assets compared with 57 percent in 1962.

The $7.7 billion of equity capital in cooperatives at the close of fiscal year 1976 included almost $1.6 billion of intercooperative equities or investments; therefore, farmers' net equity in cooperatives was about $6.1 billion.

In total, more than half of the $7.7 billion was in the form of equity certificates, book credits, and allocated reserves. A little more than a third was in common and preferred stock and the rest was in unallocated reserves or surplus. But the type of equity varied with the type of cooperative. Farm supply cooperatives, for example, had more than half of their equity in common and preferred stock. Marketing cooperatives had nearly three-fourths of their equity in equity certificates, credits, and allocated reserves.

Sale of Capital Stock And Other Capital Equities

Cooperatives, especially in getting started, need to raise capital from members. In early years some cooperatives, primarily grain and supply, sold common and preferred stock. The first share of common stock represented a membership in the organization. An effort was made to get members to "invest" capital in proportion to their expected use of the cooperative, but some farmers purchased additional stock to help the enterprise get underway.

At the close of the 1976 fiscal year, a study of 5,795 cooperatives showed that 2,741 had acquired 19 percent of their outstanding common stock by sale and 1,393 had acquired 25 percent of their preferred stock by this method.

Dividends of 8 percent or less per year (under State statutes) usually were paid on such capital. After a cooperative was established, additional capital was generally supplied by members in proportion to patronage, and dividends on capital were lowered or eliminated so that more of the net savings could be distributed as patronage refunds.

In contrast to other businesses, the usual equity financing plan of a stock cooperative provides little or no opportunity for increased growth value of capital stock as a reflection of corporate earnings. For this reason—plus limitations on dividends, voting rights, and the transfer of shares—investment in the capital stock of a cooperative has little appeal to outside investors interested primarily in capital gains.

Cooperatives that pay dividends on equity capital usually do so at a nominal rate. For fiscal year 1976, only 2 percent of net operating margins of cooperatives was used to pay dividends on equity capital. Often no dividends are paid on equity capital originating from retained patronage refunds.

Retention of Net Savings

Retention of net savings is the basic method used by cooperatives to accumulate capital. About three of every four dollars of allocated equity capital outstanding in 1976 had been acquired from savings distributed as patronage refunds and reinvested by patrons. Farm supply cooperatives have relied almost exclusively on this method, each year setting aside a portion of their savings for capital purposes.

The most common forms in which net savings are retained are: (1) Noncash or deferred patronage refunds, and (2) unallocated capital reserves or surplus.

Use of Noncash or Deferred Patronage Refunds

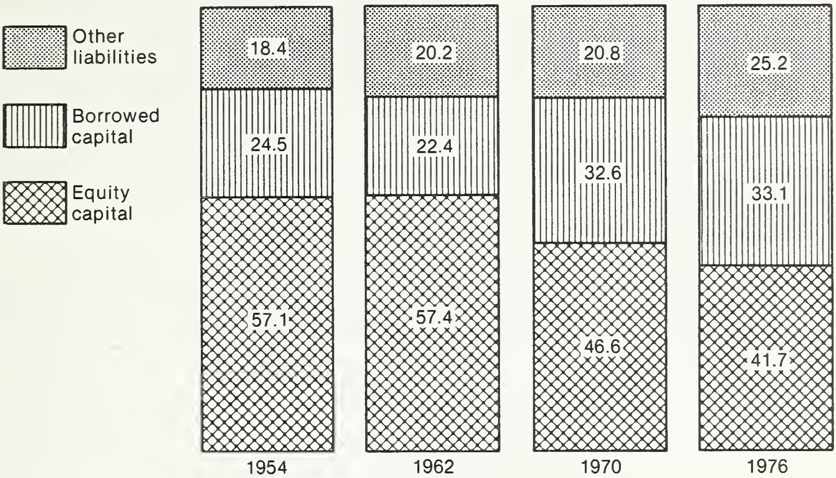
In 1976, cooperatives retained about 45 percent of their net operating margins as noncash or deferred patronage refunds. These were evidenced by various types of certificates such as shares of stock, revolving fund certificates, or other certificates of equity; or by book credits—sometimes called allocated capital reserves or patrons' equity reserves.

Cooperatives accumulate these allocated patronage refunds until they have sufficient capital, along with that from other sources, to finance needed facilities or operations. Then they may be redeemed under a revolving capital plan or some other plan (discussed in a later section).

Retention of Unallocated Reserves or Surplus

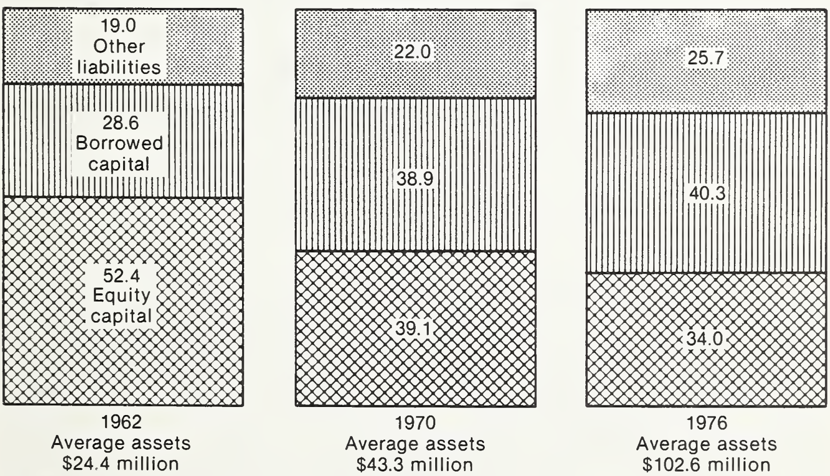
Some capital reserves also are retained on an unallocated basis. Usually derived from the cooperative's taxable income, they are generally designed to absorb possible operating losses and are sometimes established to comply with State laws. They are usually listed on balance sheets as surplus or general reserve accounts. A total of 4,820 cooperatives had $1.2 billion of unallocated capital outstanding at the close of the 1976 fiscal year.

Farmer Marketing and Supply Cooperatives
Financial Structure



Figures in bars are percent of total assets at close of fiscal years

100 Largest Farmer Marketing and Supply Cooperatives
Financial Structure



Figures in bars are percent of total assets at close of fiscal years.

Use of Per-Unit Capital Retains

Some marketing cooperatives, especially those handling fruits and vegetables, issue equity certificates to validate per-unit capital retains instead of, or in addition to, retained net savings or outright sale of securities. Per-unit capital retains are amounts that are invested in cooperatives through deductions made from sales proceeds (in compliance with a bylaw provision or membership agreement) on a physical unit basis, such as x cents per bushel, case, or hundredweight.

Cooperative bylaws may place such retains in a revolving capital fund with provisions that when the cooperative has adequate finances, the fund will be revolved. The oldest year usually is redeemed first.

In recent years some cooperatives have stipulated that the equity of each producer will be adjusted upward or downward each year based on the volume he has marketed over a base period, such as 5 or 10 years, and only the difference (net balance) added or refunded.

More than a third of marketing cooperatives' total equity at the close of fiscal year 1976 had been contributed by patrons through per-unit capital retains. This method is used extensively by marketing cooperatives on the West Coast, in Florida, and to some extent in the Northeast, but it is not very popular elsewhere. For example, three of every four dollars of equity capital of fruit and vegetable cooperatives have been acquired by per-unit capital retains compared with only 1 percent by grain cooperatives and almost none by farm supply cooperatives.

A total of 306 cooperatives had $795 million of per-unit capital retains outstanding at the close of the 1976 fiscal year.

Revolving Fund Financing

As a financing device, the revolving fund method is peculiarly cooperative. Unlike businesses where profits are shared in proportion to investment, the net margins of cooperatives are distributed according to member patronage. Early cooperatives were faced with the problem of how best to capitalize their business so the proportion furnished by each member was relative to his patronage. They developed the revolving fund plan of financing to solve this problem.

Description of the Plan

Essentially, revolving fund financing provides for retiring the oldest outstanding membership capital from funds furnished to the cooperative by members and patrons of later or current years. Ordinarily, the plan does not become fully operative until an association has accumulated adequate equity capital and is in financial position to start retiring its oldest membership equities.

The revolving fund system of financing may be compared to a stream across which a dam has been erected. In the same way that water is backed up to form a lake to furnish power to run a mill, cooperatives acquire members' capital to form a reservoir of equity capital until they have enough to run the cooperative business. When the reservoir of member capital is filled to the desired height and the cooperative has met its capital requirements, retained capital from prior years can be siphoned off and refunded to members in the order it was accumulated.

This method of financing was devised to provide cooperatives an opportunity to constantly renew their capital structures, to provide an unending source of member capital, and at the same time assure that the oldest equities would be paid back first.

Under the revolving fund plan, members' revolving equities are allocated to them on the cooperative's books (or in many cases by various types of certificates), and these equities are used to conduct the business. Except for a limited number of cooperatives having a fixed revolving fund period, members' equities are returned to them periodically in the order in which they were provided. This occurs when the board of directors decides the financial needs of the cooperative justify such action. The length of the revolving period usually ranges anywhere from 3 to 15 years, sometimes more.

In more recent years as capital needs of cooperatives have increased, many have abandoned revolving fund financing for alternative financing plans to avoid continually extending their revolving fund periods. Accelerated growth, along with current Internal Revenue Service tax regulations requiring increased cash distribution of annual net margins, make it difficult for cooperatives to retain enough current net margins to meet current financing requirements and at the same time revolve old equity capital allocations.

Modifications of Revolving Fund Financing

Some cooperative leaders have questioned whether the revolving fund financing system has outlived its usefulness. When a cooperative has been in business for many years and part of its membership has become inactive, when deliveries of products to the cooperative have become irregular, and when the revolving fund period has been of extended duration, substantial financial inequities among members can arise. Also, as cooperatives look to the future and begin to modernize and expand their operations and facilities, many realize that more capital will be needed than can be acquired or retained through the traditional revolving fund approach.

As a result, some cooperatives have switched to a base capital plan of financing, a modification of the traditional revolving fund plan. The base capital plan temporarily freezes existing capital requirements, then annually determines how much capital is required of each member, generally based on relative patronage over a specified number of years. Instead of full retention or revolvement of funds, a *net* retention or revolvement is calculated, based on extent to which a member's existing capital does not measure up to his requirement, or exceeds it.

In recent years, several financing plans of this general type have been adopted, primarily by marketing cooperatives in California and Florida. These plans represent an important trend in the equity financing of cooperatives. They have two major advantages: First, correcting member inequities in capital investments so current member investments are in line with current use; and second, improving the predictability and reliability of capital sources—important in financial planning.

Financing With Debt Capital And Other Funds

Cooperatives obtain debt capital—that is, incur legal liability to repay borrowed funds by a specified time under stated conditions—from members, nonmembers, and lending institutions.

Cooperatives generally evidence debt capital in conformance with the requirements of the various banks and other lending institutions or individuals from whom they borrow funds.

A total of 4,559 cooperatives had over $6.1 billion of borrowed funds outstanding at the close of the 1976 fiscal year.

Sources of Borrowed Funds

The cooperative Farm Credit System—through the 12 district Banks for Cooperatives and the Central Bank for Cooperatives—is an important source of short, intermediate, and long-term credit for farmer cooperatives. Banks for Cooperatives provided 62 percent of cooperatives' total borrowed funds outstanding at the close of fiscal year 1976. This compares with 64 percent in 1970, 50 percent in 1962 and 46 percent in 1954.

Cooperatives also look to various other sources for capital. Debt instruments of all types provide an important source of credit for cooperatives. They obtain about a fifth of their total borrowed funds from members, patrons, and outsiders through sale or issuance of certificates of indebtedness, debenture bonds, promissory notes, and other debt securities—both short- and long-term.

Some cooperatives raise external funds from nonmember investors and creditors. This gives them greater leverage; that is, they can borrow additional capital on a smaller percent of net worth. The member thus has a lower investment and the creditors share a greater portion of the risk. This practice results in a favored position for the membership, but only so long as the cooperative realizes a return on its assets sufficient to justify the additional leverage.

The amount of debt financing needed, custom, legal requirements, security, repayment provisions, loan costs, purpose of the loan, availability of funds, bargaining position, and caliber of management are factors in determining not only the lending source but the terms of a particular loan arrangement.

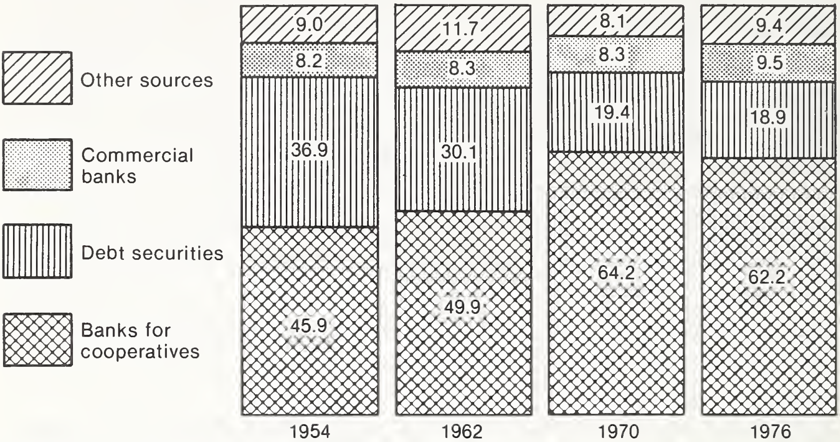
Caliber of management and repayment ability often assume greater importance in cooperative loan negotiations than the nature of the security offered.

A number of the larger cooperatives are acquiring limited amounts of new capital by selling fixed-income securities both to members and the public—including debenture bonds, and long- and short-term notes. These securities are issued as debt capital with maturity dates, and may be issued to members or to anyone. A few cooperatives engaged in interstate commerce register their securities with the Securities and Exchange Commission.

Some cooperatives also record allocated retentions of net margins in the form of certificates of indebtedness or other debt paper. That is, they issue paper with a maturity date that bears

Farmer Marketing and Supply Cooperatives

Sources of Borrowed Capital, Based on Amounts Outstanding at the End of Fiscal Years

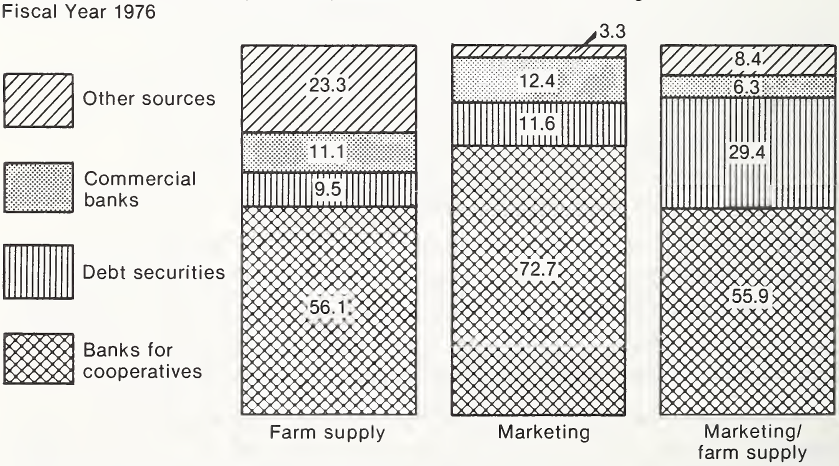


Figures in bars are percent of total borrowed capital.

Farmer Marketing and Supply Cooperatives

Sources of Borrowed Capital

By Major Function of Cooperatives, Based on Amounts Outstanding at Close of Fiscal Year 1976



Figures in bars are percent of total borrowed capital.

interest and may be transferrable, just as nonpatronage debt paper.

Interest paid by cooperatives on outstanding indebtedness varies according to supply and demand factors affecting the cost of money acquired in a particular debt arrangement.

Use of Depreciation Reserves

In determining the net savings, or final pool payments, of a cooperative each year, depreciation of buildings and equipment is a noncash expense and the amount is credited to a "reserve for depreciation" account. Therefore, cash funds equal to the annual depreciation become available for use in financing other fixed assets or operating needs. Or they can be placed in investments for future replacements of facilities or other needs.

Annual depreciation may be substantial in cooperatives owning their buildings and equipment. For example, the "source and use of funds" statements for a group of supply/marketing cooperatives in the central United States showed that depreciation totaled $4.1 million compared to net savings of $1.3 million. And a large supply cooperative in the Southeast had depreciation and amortization expenses of $2.4 million and a net margin of $5.6 million.

Many cooperatives thus rely on funds from depreciation expense to help make annual payments on notes or mortgages used to finance new facilities or services.

Other noncash expenditures, or reduction in net savings not requiring funds, are bond discounts, organization expenses, and in some cases, reserves for bad debts.

Use of Accounts Payable

In addition to formal loans, farm supply cooperatives also obtain financing from their wholesale suppliers through the credit extended on merchandise purchases. Marketing cooperatives obtain similar financing simple because of the time lag between receipt of commodities from member-patrons and actual settlement with them.

Farm supply cooperatives usually owe suppliers for a considerable portion of their inventory. These debts are reflected in the balance sheets as "accounts payable." Trade suppliers sometimes take a second position behind a bank's first mortgage. Some have "patrons' advances against future purchases" outstanding at certain times of the year. Likewise many marketing

cooperatives have accounts payable for unsold products marketed by members and accounts payable for containers and packaging supplies.

The extent that cooperatives operate on the funds of suppliers varies with the credit policies of suppliers, the financial condition of the cooperatives, the discounts for prompt payment, and the business policies of cooperative management. Supply cooperatives may receive 10 to 30 days' and sometimes 60 days' credit without incurring interest charges.

Two examples illustrate the use of accounts payable. A group of supply-grain cooperatives in the central part of the country had $16 million of accounts payable compared with $17.7 million of inventories on hand. And a large centralized supply cooperative had $5.8 million of trade accounts payable compared with $19.7 million of merchandise inventories.

Financial Position and Operations Of Cooperatives

Combined Balance Sheet At End of Fiscal 1976

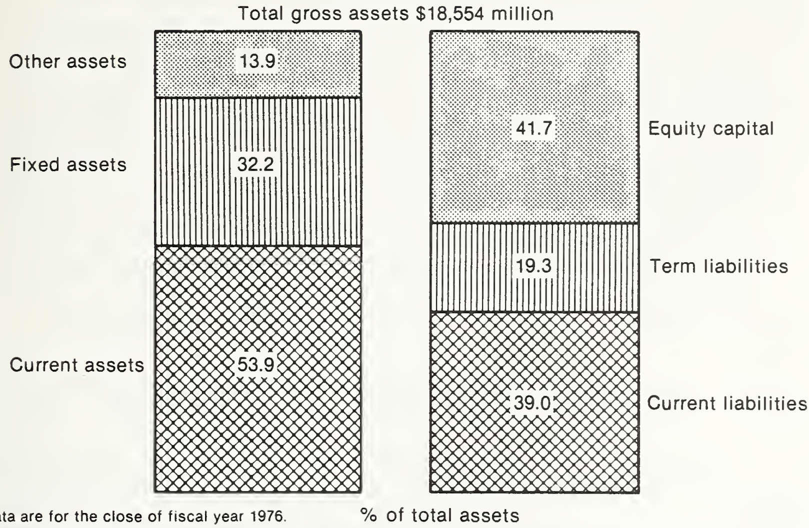
Capital requirements of cooperatives have increased greatly along with the prices of farm inputs, farm products, labor, and other operating items. Marketing and supply cooperatives had an estimated $18.5 billion in assets at the close of their 1976 fiscal year compared with $8.5 billion in 1970. After eliminating intercooperative investments, net assets totaled about $17 billion in 1976 compared with $7.7 billion in 1970.

Condensed balance sheet information at the close of fiscal year 1976 was as follows:

Assets	Billion dollars	Liabilities	Billion dollars
Current	10.0	Current	7.2
Fixed (net)	5.9	Fixed	3.6
Other	2.6	Member equity or net worth	7.7
Total	18.5	Total	18.5

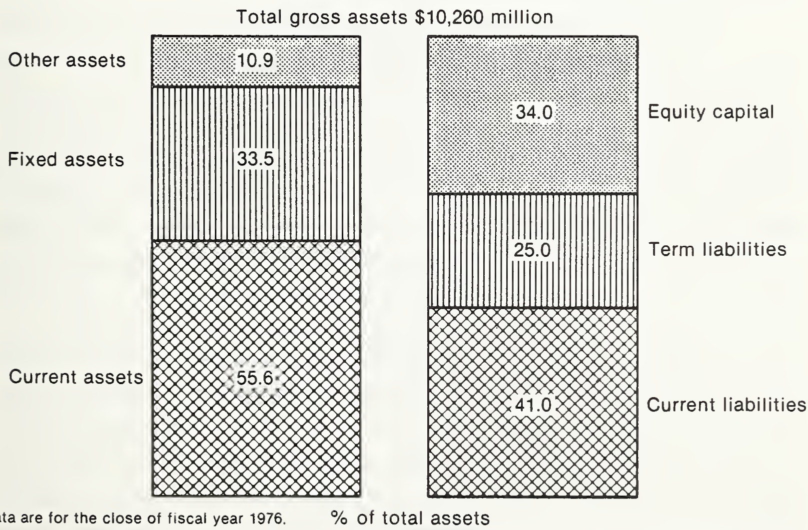
Members' equity as a percent of total assets has been declining in recent years as more reliance has been placed on borrowed funds. Equity capital decreased from 57 percent of total assets in 1954 and 1962 to 47 percent in 1970, and 42 percent in 1976.

Condensed Balance Sheet Data for 5,795 Farmer Cooperatives



Data are for the close of fiscal year 1976.

Condensed Balance Sheet Data for the 100 Largest Farmer Cooperatives



Data are for the close of fiscal year 1976.

The types and amounts of equity capital outstanding at the close of fiscal year 1976 were as follows:

Type	Million dollars
Common stock	1,261
Preferred stock	1,395
Membership fees (nonstock)	33
Qualified certificates of equity and book credits	3,786
Nonqulaified equity allocations	85
Unallocated reserves or surplus	1,167
Total	7,727

Sources and Uses of Funds Statements

Cooperative officials analyze financial and operating statements by: (1) Comparing balance sheet items at the end of the month or year with those at any earlier date; (2) comparing operating results for one period with an earlier period and with the budget; and (3) calculating various financial ratios.

Cooperatives also show changes in their financial position through statements of "sources and uses of funds." These usually show the flow of funds during the year, including the increase or decrease in working capital. Accounting and auditing firms now make it a standard practice to include such statements with the balance sheet and operating statement.

Neither the operating statement nor the balance sheet alone can show the cause and effect of changes in assets and the flows of financial resources. Comparative balance sheets, for example, show only the net change in an item compared with a month or year ago whereas the "source and use" statement shows the additions and deductions during the period. The more common information shown is: (1) Cash funds available from net margins in the operating statement, including those from the current year's depreciation; (2) purchase and sale of fixed assets; (3) sale and redemption of capital stock and other capital equities; (4) purchase and redemption of investments in other cooperatives; (5) increases and reductions in long-term notes payable and debentures; (6) cash payment of dividends on capital stock, if any, and patronage refunds; and (7) the net increase or decrease in working capital (current assets minus current liabilities).

A "sources and uses of funds" statement indicates factors responsible for generating working capital inflows and outflows; it also reveals the significance of activities bypassing working capital such as noncash refunds from a regional cooperative added to investments, or capital stock issued in payment for the facilities of a merging cooperative. It thus provides managers and boards of directors a more complete picture of the nature and scope of financial changes.

Following is an abbreviated example of a "source and use of funds" statement:

Source	Amount	Use	Amount
Net margins	$20,000	Increase in fixed assets	$28,000
Capital retains	13,000	Investment in other co-ops	8,000
Depreciation	21,000	Reduction of long-term debt	21,000
Long-term loans and debentures	25,000	Revolvement of member equities	22,000
Sale of fixed assets and investments	12,000	Cash payment of dividends and refunds	8,000
Sale or issue of member equities	9,000	Increase in net working capital (current assets minus current liabilities	13,000
Total	100,000	Total	100,000

Combined Net Margins And Their Distribution In 1976

Cooperatives marketing farm products use two principal methods to pay for farm products: (1) Payment at time of purchase; and (2) payment of a cash advance at time of delivering the product to a pool—frequently followed with a second advance payment, and a final payment of proceeds remaining after deducting expenses and closing the pool.

Most grain cooperatives, some dairy and cotton cooperatives, and all farm supply cooperatives operate on a purchase-and-sale basis. They have net margins available for distribution to member-patrons.

Most fruit and vegetable and some dairy and other types of marketing cooperatives operate on a pooling basis. They may make cash advances and final payments to patrons and thus have

little or no net margins on their marketing operations. They generally obtain member investment capital by means of per-unit capital retains.

A few cooperatives use a third method of payment where they act as an agent for farmers and sell their products on an individual account or lot basis. These cooperatives maintain the identity of a farmer's product until it is sold. The cooperative negotiates the sale, collects the money, deducts the costs incurred, and returns the remainder to the producer along with an itemized account of the transaction. This method enables the grower to determine the date of sale and he assumes all the risks of a fluctuating market. The cooperative operating in this manner needs little working capital.

Cooperatives operating on a purchase-and-sale basis usually pay the going market price for farm products and sell farm supplies at prevailing market prices in their trade areas. Any net margins (net savings or net income) remaining after deducting operating expenses are distributed as patronage refunds in accordance with bylaw provisions and board actions.

Gross margins are the difference between sales and cost of sales. Net margins represent the amount remaining from gross margins after deducting all expenses.

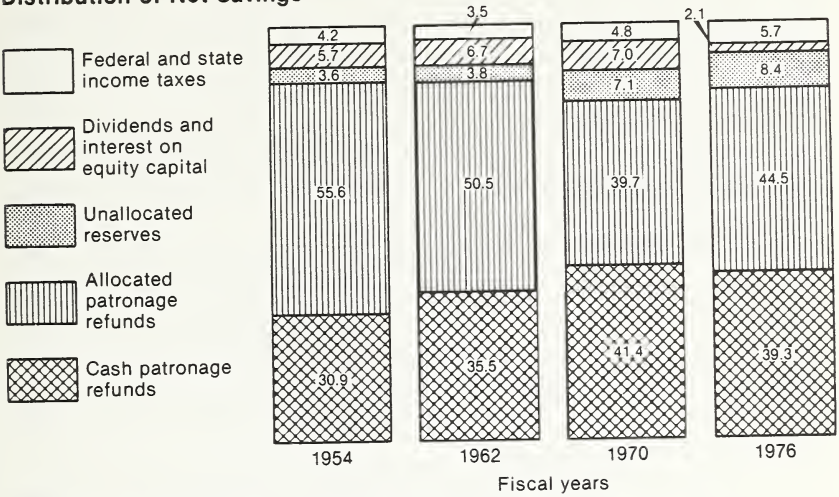
Bylaws of cooperatives usually contain provisions for distributing net margins annually. Many specify whether this distribution is to be made to members only or to all patrons, but leave the rate of dividend, if any, on capital stock, the amount or percent to go to capital reserves, and the amount and rate of patronage refunds (including the proportion in cash and noncash) to the discretion of the board of directors. Some State statutes require that at least 10 percent of net margins be placed in a capital reserve until it reaches a specified amount or percent of the outstanding member capital.

Income tax laws and regulations also influence the method of distribution. For example, if a cooperative operates under Section 521 of the Internal Revenue Code on a so-called income tax exempt basis, then it must distribute patronage refunds on the same basis to all patrons (disregarding business done with the Government).

Distribution of net margins varies widely among cooperatives. Many do not pay any dividends on capital stock; some may have a small net margin and retain all of it in an unallocated reserve or pay out only a dividend on their member capital; others

Farmer Marketing and Supply Cooperatives

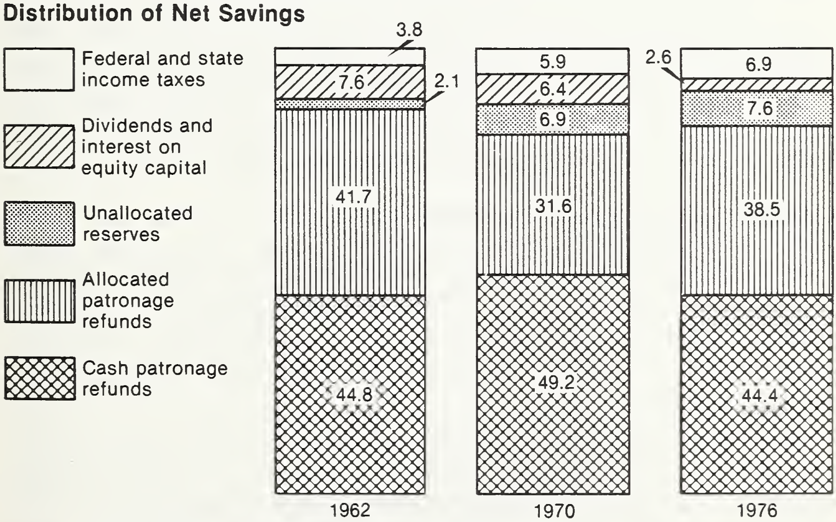
Distribution of Net Savings



Figures in bars are percent of total net savings at close of fiscal years.

100 Largest Farmer Marketing and Supply Cooperatives

Distribution of Net Savings



Figures in bars are percent of total net savings at close of fiscal years.

may distribute a relatively small proportion as a patronage refund; while others may distribute all net margins as refunds.

Of cooperatives' $1.8 billion combined net operating margins for 1976, almost 85 percent was distributed as patronage refunds on the current year's business—40 percent in cash and 45 percent as allocated capital credits. Seven percent was retained as unallocated reserves; 2 percent was used to pay dividends on equity capital; and the other 6 percent was used to pay Federal and State income taxes.

Some cooperatives distributed net margins in a manner that no income taxes were due; that is, they distributed all their net margins as patronage refunds. Others distributed only a small portion as patronage refunds so they could pay dividends on equity capital or increase their unallocated reserve accounts. Some paid all patronage refunds in cash while others paid only the required 20 percent in cash.

Some retained only the net margins, after taxes, on nonmember business. Others retained a portion of the net margins from both member and nonmember business to build up tax-paid capital reserves.

Net margins, after deducting net losses, of farmer marketing and supply cooperatives totaled $1.8 billion in fiscal year 1976 compared with $478 million in fiscal 1970. After excluding dividends on capital and patronage refunds from intercooperative business, the net amount in 1976 was $1.3 billion—compared with $430 million in 1970.

In cooperatives with net margins to distribute, the proportion paid in cash patronage refunds has increased from about 31 percent in 1954 to 40 percent in 1976; while the percentage distributed in noncash patronage refunds decreased from 56 percent to about 45 percent of the total.

Computing Patronage Refunds

Declaration and distribution of patronage refunds involve the following questions: (1) When or how often; (2) to whom—member-patrons or all patrons; (3) on what basis—products, departments, or total sales or purchases; and (4) in what form—cash or noncash.

Net margins may be computed on a monthly, quarterly, or annual basis, but most cooperatives declare patronage refunds annually. They are distributed within 8 months after the close of their fiscal year to comply with Internal Revenue regulations.

About 57 percent of the farmer cooperatives distribute patronage refunds only to member-patrons. The remainder distribute them to all patrons to comply with Section 521 of the Internal Revenue Code for operating on a so-called tax exempt basis.

Information is not available on all cooperatives' basis for declaring patronage refunds. Some pay one rate on total business; some pay refunds on a divisional or functional basis such as on volume of farm products marketed and on farm supplies sold; some calculate refunds by departments within a division—such as on wheat in one department and coarse grains in another; and others use a combination of methods.

Some marketing cooperatives declare a separate rate per unit—such as per bushel, bale, or hundredweight—on major commodities. Others establish one rate on all commodities, or use a single pool. Some supply cooperatives declare refunds as a percent of dollar sales and others calculate separate rates per unit—such as per ton, gallon, or pound—on major supply items, ie. anhydrous ammonia or on a major group of supplies such as mixed feeds.

Per-Unit Capital Retains Accumulated in 1976

Of 5,795 cooperatives studied in fiscal year 1976, 270 reported retaining $129 million of per-unit capital retains from sales proceeds for the year. This compares with $78 million in 1970. Total per-unit capital retains included in allocated equity capital outstanding at the close of fiscal year 1976 amounted to $795 million by 306 cooperatives.

Pooling Operations

Per-unit capital retains are used almost entirely in cooperatives operating on a pooling basis. In pooling operations, most cooperatives assume title to the products and thus have full discretion in selling them; but if no advances or only moderate advances are made to members for their products, the cooperatives carry little of the inventory risk. Pooling is found most frequently in the marketing of fruits and vegetables, and tree nuts. It is also used to some extent in marketing dairy products, poultry and poultry products, seeds, and livestock and wool.

Pooling is an averaging process—an averaging of expenses and returns for the specific kind and quality of product placed in

a pool. It is a means of spreading market risks.

Cooperatives operating on a pooling basis usually comingle the products of many producers, and after selling these and deducting expenses, they pay the producers the average price received—generally on the basis of established grades. Cash advances usually are made to producers when products are received and as the products are sold. Producer investments, ordinarily in the form of per-unit capital retains, usually are withheld and deducted from sales proceeds to help finance the cooperative.

Pooling cooperatives normally allocate operating costs to producers on a patronage basis in one of three ways: (1) Make a uniform or flat charge per unit marketed, such as per bushel, crate, or hundredweight; (2) deduct actual expenses from sales receipts; or (3) use both methods.

Most cooperatives operating on a pooling basis are of the nonstock type and finance operations through a nominal membership fee plus retains from sales proceeds.

Final pool payments or settlements may represent a large or a small proportion of the total sales proceeds realized from a patron's marketings. If several advances are made, the final payment may be about the same as the net savings of cooperatives operating on a purchase-and-sale basis.

If the pool is not settled by the end of the fiscal year, the cooperative may establish its value based on the current market price and determine a net margin to comply with Internal Revenue regulations.

Financing Trends and Planning

As cooperatives have become larger and more diversified and integrated, they have adjusted and expanded their financing methods. These have included changes in acquiring both equity and debt capital. Following are some of the changes that have occurred and projections for the next decade.

Financing Trends

Equity certificates and allocated reserves are making up a larger percent of total equity capital. At the close of fiscal year 1976, capital stock constituted 34 percent of total equity capital; nonstock equity certificates and credits, 51 percent; and unallocated reserves or surplus, 15 percent. This compares with 45

percent, 43 percent, and 12 percent for these items in 1954. These data indicate a shift over the past 22 years to the use of more nonstock equity capital. This trend has developed for a number of reasons. These include (1) the requirements to qualify for tax treatment under Section 521 and Subchapter T, as amended, of the 1954 Internal Revenue Code; (2) the impact of higher income tax rates; (3) the influence of financing programs of regional farm supply and grain cooperatives on member local associations; and (4) the preference for more nondividend bearing equities allocated to member-patrons in proportion to their use of the cooperatives.

The trend to using more nonstock types of equity capital may continue. Also, the proportion of equity capital in unallocated reserve accounts may increase as more cooperatives cease to qualify as so-called income tax exempt associations under Section 521 of the Internal Revenue Code.

Debt financing has increased in proportion to equity financing. In the early years, members' equities or net worth provided substantially more than half of many cooperatives' needed assets. In 1936, for example, in 10,547 cooperatives' net worth was 56 percent of assets, but in about 50 percent of the group net worth exceeded 70 percent of their assets. In more recent years, with the need for much larger amounts of capital, this ratio has been decreasing until it is less than 50 percent of assets in many cooperatives. In fact, in 1970 a study of 7,289 marketing and supply cooperatives showed equity capital was down to 47 percent of assets; in 1976, equity capital of 5,795 cooperatives was only 42 percent of their assets. This trend may continue as more of the medium and smaller cooperatives strengthen their financial position and become eligible for more credit.

Revolving capital plans are being replaced with base capital financial plans. As mentioned, increased capital needs have caused some cooperatives to look for other plans to avoid extending their revolving periods. Some have adopted modified revolving fund plans. Also, as farm supply cooperatives located in or near areas of suburban development increase their earnings on nonfarm business, these earnings usually are retained as unallocated reserves or surplus.

More attention is being directed to retiring the capital stock and allocated equities held by estates and inactive members. A number of cooperatives without revolving fund plans recently

have begun setting aside reserves to redeem equities in estates and from persons who are no longer producers, who have moved out of the trade area, or who have reached a specified age. Membership and capital turnover is a continuous problem of all cooperatives, and a definite plan for retiring capital in a fair and systematic manner fosters good member relations and facilitates the sale of cooperative equities to new or current members.

Many cooperatives need to develop more equitable financing plans to provide for the orderly accumulation and redemption of member equities.

Use of lease-back and leverage leasing is increasing. More risk-shifting and special purpose financing techniques are being used by some of the larger cooperatives. These techniques are expected to become much more widespread in the future.

Some cooperatives make use of the lease-purchase method of financing to gain the use of facilities without tying up working capital in long-term fixed facilities. A cooperative may lease fixed assets directly from the owner, or it may sell all or part of its own fixed assets to another firm that will in turn lease these facilities back to the cooperative.

A more recently developed variation of leasing is "leveraged leasing," which differs from single investor leasing in that the lessor borrows from institutional lenders a major portion of the purchase price of the asset under lease, providing 20 to 40 percent of the purchase price as equity investment. The institutional lenders hold a first lien on the assets and an assignment of the lease and lease rental payments.

Usually, the term of a leveraged lease will cover all or most of the asset's useful life, and the aggregate lease payments will liquidate the debt to institutional lenders and, together with the asset's residual value, will provide the lessor with a return on his investment.

An important advantage of leveraged leasing to the lessor lies in retaining ownership of the asset, which enables him to use the investment tax credit and accelerated depreciation to maximize cash flow. Part of this benefit is passed on to the lessee in the form of a lower lease rate. This was a particularly attractive feature for a cooperative lessee until 1979 when the investment tax credit laws were changed, because cooperatives were not in a position to use the full investment tax credit.

Several cooperatives used leveraged leasing in the 1970's to finance large capital projects, such as fertilizer and food processing plants. Because of its complexity and the involvement of several parties, leveraged leasing was most appropriate for relatively large transactions, perhaps $5 million or more.

Sale of industrial development bonds is increasing in the financing of facilities. Another development in long-term financing that has received considerable attention in the 1960's and 1970's is the sale of tax-exempt industrial revenue bonds. They offer the opportunity for long-term payout at the relatively low interest rates available to local governmental units. Such bonds are generally issued by a municipality or other local governmental authority in connection with a specific project, usually to stimulate business or industrial activity and employment in the local area. The owner of the project (cooperative or other business firm) undertakes to repay the bonds with interest, in accordance with the established amortization schedule. As a result, the cooperative is able to acquire assets at a significantly lower aggregate cost than would be the case if normal mortgage financing had been used.

If the circumstances are right, industrial revenue bonds offer an excellent source of relatively low cost long-term financing of capital projects. Of course, problems can be encountered in fitting the project and location together at the most propitious time.

Using industrial revenue bonds to finance a new plant (or other project) has three main advantages over cooperatives' typical debt financing: (1) The bonds provide 100 percent financing; (2) they cover a period about equal to the useful life of the plant; and (3) the capital costs of the plant will be borne by the current member-patrons, not past or future members of the cooperative.

More attention is being given to the planning and management of capital. Inflation and high interest rates, the demand for credit from patrons, and the increasing size of cooperatives have accentuated the importance of better capital planning and management.

Long-Range Financial Planning

Cooperatives may be in a more favorable position than other businesses to gauge and relate their financial requirements to the economic needs of their patrons. They have potentially greater opportunities to do forward financial planning because of

their inherently close-knit relationships with their patrons who have a member-owner interest in the affairs of their cooperative.

On the other hand, a cooperative's relatively limited field of membership serves to restrict the scope, if not the quality, of its financial planning.

Like other businesses, management of cooperatives is concerned with the availability of capital, the terms under which it is acquired, and the problems of allocating it among the assets to be financed.

Financial managers of cooperatives must also keep in mind at all times the financial needs and cash flow problems of their member-patrons. This is particularly true in allocating retained net margins and per-unit capital retains because member-patrons are subject to income tax on these in the year allocated unless the cooperative pays the tax.

Owing to the overwhelming need for capital at the farm level and the high return available on invested savings, farmers are becoming more conscious of the rate of return realized by their cooperatives. Cooperative members, who are usually debtors, are reluctant to leave more funds in their cooperatives than those required to provide the necessary risk capital base to secure borrowed funds. This means that permanent debt financing has become a way of life for many cooperatives just as it has for corporate business.

A responsibility unique to cooperative management is to conduct the financial affairs of the association so its cooperative character is maintained or enhanced. A cooperative's financial policies have a significant impact on its degree of adherence to the cooperative principles of operation at cost, limited returns on member capital, membership investment, and control by those who use its services.

As changes occur in members' type and size of farms, their input requirements, and marketing services they need, it becomes increasingly important for cooperative managers and directors to make long-range financial plans.

Federal Income Taxation

Over the years, perhaps the most talked about and least understood aspect of farmer cooperatives has been their tax treatment and obligation. Usually, the specific questions have related to income tax. Discussion has encompassed what tax, if any, is paid, who pays it, when it is paid, how it is paid, and why the tax

treatment of cooperatives differs from that of other corporate businesses.

Central to understanding the income tax treatment of cooperatives is understanding the business objective of their nonprofit operations. The cooperative operates to provide its members goods and services at cost. If benefits from participation in the cooperative increase the member-owners' incomes, then they incur a higher tax liability.

Because the "at-cost" amount is impossible to determine for each item or service at the time of transaction, the competitive market price is generally used. At the end of the year, net margins and their allocation to member-patrons are determined by the board of directors in accordance with bylaw provisions.

Cooperative members use various methods to determine how much of the net margin and the net proceeds from their products they want returned to their farming operations and how much they want to leave in the cooperative to finance its continued operation.

The Internal Revenue Code of 1954, as amended by the Revenue Act of 1962, the Foreign Investors Tax Act of 1966, and the Tax Reform Act of 1969, contains special provisions on the tax treatment of (1) certain farmers' associations which qualify thereunder, and (2) all corporations operating on a cooperative basis to which the revised statute specifically applies.

Present Federal income tax statutes assure that a tax will be paid at either the cooperative or member-patron level. If a cooperative declares a patronage refund, at least 20 percent must be paid in cash if the entire patronage refund is taxed at the patron level—as a qualified patronage refund. If a cooperative is adequately financed, it may pay a higher amount—up to 100 percent—in cash. However, if it needs additional capital then it may retain the remaining 80 percent of the patronage refund and show each member-patron's ownership of it by issuing some type of qualified equity certificate or allocating it on the books and sending each patron a statement. Regardless of the cash and noncash proportion, the member must pay income tax based on his full qualified allocation.

Pertinent sections of the Internal Revenue Code of 1954 relating to marketing and supply associations are Sections 521, 1381, 1382, 1383, 1385, and 1388 (the latter five sections comprising Subchapter T of the Code added by the Revenue Act of 1962, as amended in 1966 and 1969) and Section 6044.

Section 521 Cooperatives

Those farmer cooperatives that qualify under Section 521 of the Code generally operate so as to have little or no taxable income. They are often referred to as tax exempt associations. Associations that do not qualify under Section 521 are liable for income tax on net income used to pay a return on capital and on receipts not distributed to patrons as true patronage refunds in the manner prescribed by the Code.

In 1976, 43 percent of the active farmer cooperatives met the requirements specified in Section 521, and thus qualified for the tax treatment provided in Part I of Subchapter T. The chief requirements for such qualification are these:

1. It must be a farmer, fruit grower, or like association organized and operated on a cooperative basis to (a) market the products of members or other producers, or (b) purchase supplies and equipment for the use of members or other persons.

2. Substantially all of its stock (other than preferred non-voting stock) must be owned by producers marketing products or purchasing supplies through it if it is organized on a capital share basis.

3. The dividend rate on capital shares must not exceed the legal rate of interest in the State of incorporation, or 8 percent a year, whichever is the greater, based on the value of the consideration for which the capital share was issued.

4. Financial reserves are restricted to those required by State laws or those that are reasonable and necessary, and must be allocated to patrons unless the cooperative includes them in computing taxable income.

5. The business with nonmembers may not exceed 50 percent of the cooperative's total business, and the purchasing for persons who are neither members nor producers may not exceed 15 percent of the cooperative's total purchasing.

6. Nonmembers are to be treated the same as members in such business transactions as pricing, pooling, or payment of sales proceeds, in price of supplies and equipment, in fees charged for services, or in the allocation of patronage refunds to patrons.

7. Permanent records of the patronage and equity interests of all members and nonmembers must be maintained.

8. The legal structure of the organization must be cooperative in character and contain no provisions inconsistent with

these requirements, and the association must be actually operated in the manner and for the purpose outlined in the requirements.

In computing its net income, an organization qualifying under Section 521 may, in addition to all other deductions authorized by law, deduct:

1. Amounts paid by it during the taxable year as dividends on capital stock; and

2. Amounts paid to patrons, or allocated and disclosed to each patron in the manner authorized in Subchapter T, with respect to income during the taxable year which is derived from sources other than patronage (as, for example, rents received, investment income, gain on sale of depreciable property and capital assets, and income from business done with or for the United States Government).

A Section 521 association also may exclude from gross income patronage refunds (called "patronage dividends" in the Code) and per-unit capital retain allocations returned in the form and within the time prescribed in Subchapter T.

Non-section 521 Cooperatives

A cooperative that does *not* qualify under Section 521, often called a nonexempt association, but is covered by the definition in Subchapter T, files a regular corporate income tax return but is entitled to exclude from its gross income patronage refunds and per-unit retain allocations paid in the form and within the time prescribed in Subchapter T. Such a cooperative operates under the same rules applicable to the Section 521 cooperative.

Section 1388 (a) of the Code defines a patronage refund to mean an amount paid to a patron by a cooperative: (1) On the basis of quantity or value of business done with or for such patron; (2) under an obligation existing before the cooperative received the amount paid; and (3) according to the net earnings of the cooperative from business done with or for its patrons.

The last sentence of the section provides that a patronage refund shall not include amounts paid (a) out of earnings other than from business with or for patrons, or (b) out of earnings from business with patrons who receive either smaller or no patronage refunds for substantially identical transactions.

Exclusion of Patronage Refunds And Per-Unit Capital Retains

For cooperatives to exclude patronage refunds, they must be distributed in cash or in "qualified written notices of allocation" that the patron has (1) the option to redeem in cash during a 90-day period after issuance, or (2) consented to treat the refund as his current income. The patrons may give this consent individually in writing, the cooperative bylaws may require members to give this consent, or the patrons may consent by endorsing and cashing a check representing at least 20 percent of the total patronage refund. In any event, an allocation is deductible only if at least 20 percent is paid in cash.

To deduct per-unit retain allocations in arriving at their gross income, cooperatives must distribute them to patrons in the form of "qualified per-unit retain allocations" in payment for products marketed for them. The amount of such allocation is made without reference to the net earnings of the organization and conforms to an agreement between the cooperative and the patron. To "qualify" the per-unit retain allocation, the patron must consent to treat as income its stated dollar value. The patron may give this consent individually in writing, or the bylaws of the cooperative may require members to give this consent.

If cooperatives to which Subchapter T applies do not pay their patronage refunds or per-unit retain allocations in the form prescribed, they must include such "nonqualified allocations" in their income in the year issued. However, a deduction may be taken in the year in which a nonqualified allocation is redeemed in cash. If, at that time, the cooperative is not able to make use of a deduction, it may obtain a refund of the taxes paid on this amount in the year the allocation was made.

Under the law, any patronage refund or other distribution by a Section 521 cooperative that the cooperative may exclude from its gross income must be included in the income of the patron when he receives notice of it, if the amount arises from business activity of the patron. Also distribution in redemptions of "nonqualified allocations" can be included in the year received if they affect the patron's income from a business and do not arise out of personal living items. Thus, this legislation established the principle of a single tax on taxable income currently generated through cooperative enterprises.

Steps Necessary to Qualify

If a farmer cooperative desires to qualify for special tax treatment under Section 521 the regulations require it to request a "letter of exemption." It may obtain such a letter by filing an application on Form 1028 with the District Director of Internal Revenue Service for the district in which its principal place of business is located.

Once the letter of exemption is granted, it is not necessary to refile unless substantial changes occur in the organization or its activities. However, any such changes must be reported with the annual returns.

Exemption continues only so long as the legal setup and the operating methods comply with the requirements of the applicable statute and regulations. Hence a change in status can occur even though the letter of exemption is not withdrawn or canceled.

Returns to File

Annual returns by all cooperatives subject to Part I of Subchapter T must to be filed by the 15th day of the 9th month following the close of the taxable (calendar or fiscal) year of the cooperative.

Cooperatives that qualify under Section 521 file their return on Federal income tax Form 990-C, and all others use the standard corporate Form 1120. Cooperatives that do not qualify under Section 521 can use the longer filing period only by showing they are obligated to distribute—or have actually distributed—at least 50 percent of their patrons' net margins as patronage refunds.

All farmer cooperatives must report to the Internal Revenue Service all payments of interest, refunds, patronage dividends, per-unit retain allocations, and amounts paid in redemption of nonqualified allocations (as these terms are defined in the Code) of $10 or more a year to any one person and also send a statement of these payments to the recipient indicating the amount in each category reported. The statements must show the name, address, and account number of the recipient. Heavy penalties are imposed for failure to make these reports.

Reports required are: (1) In the case of dividends and interest, for amounts paid on or after January 1, 1963; (2) in the case of patronage dividends (refunds), for amounts paid on or

after the first day of the first taxable year of the cooperative, beginning on or after January 1, 1963; and (3) in the case of per-unit retain allocations, for amounts paid for calendar years after 1966. The reports must be furnished to the Government on or before February 28 of the year after the calendar year for which the return is made; the statement must be sent to the payee on or before January 31 of that year.

State Income Taxes

State income tax statutes and regulations generally follow basic Federal statutes and regulations applicable to cooperatives. They permit deductions of patronage refunds from taxable income, provided there is a preexisting obligation to distribute these funds to patrons. States, of course, vary as to how they handle such items as income from nonpatron business and interest payments on member equities. Also, States differ as to taxation rate and when and how cooperatives may qualify to exclude members' or patrons' patronage obligations.

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☆ U.S. GOVERNMENT PRINTING OFFICE: 1981 — 724-121/819 REGION 3-1

U.S. Department of Agriculture
Agricultural Cooperative Service

Agricultural Cooperative Service provides research, management, and educational assistance to cooperatives to strengthen the economic position of farmers and other rural residents. It works directly with cooperative leaders and Federal and State agencies to improve organization, leadership, and operation of cooperatives and to give guidance to further development.

The agency (1) helps farmers and other rural residents obtain supplies and services at lower costs and to get better prices for products they sell; (2) advises rural residents on developing existing resources through cooperative action to enhance rural living; (3) helps cooperatives improve services and operating efficiency; (4) informs members, directors, employees, and the public on how cooperatives work and benefit their members and their communities; and (5) encourages international cooperative programs.

The agency publishes research and educational materials, and issues *Farmer Cooperatives*. All programs and activities are conducted on a nondiscriminatory basis, without regard to race, creed, color, sex, or national origin.